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FORTUNE

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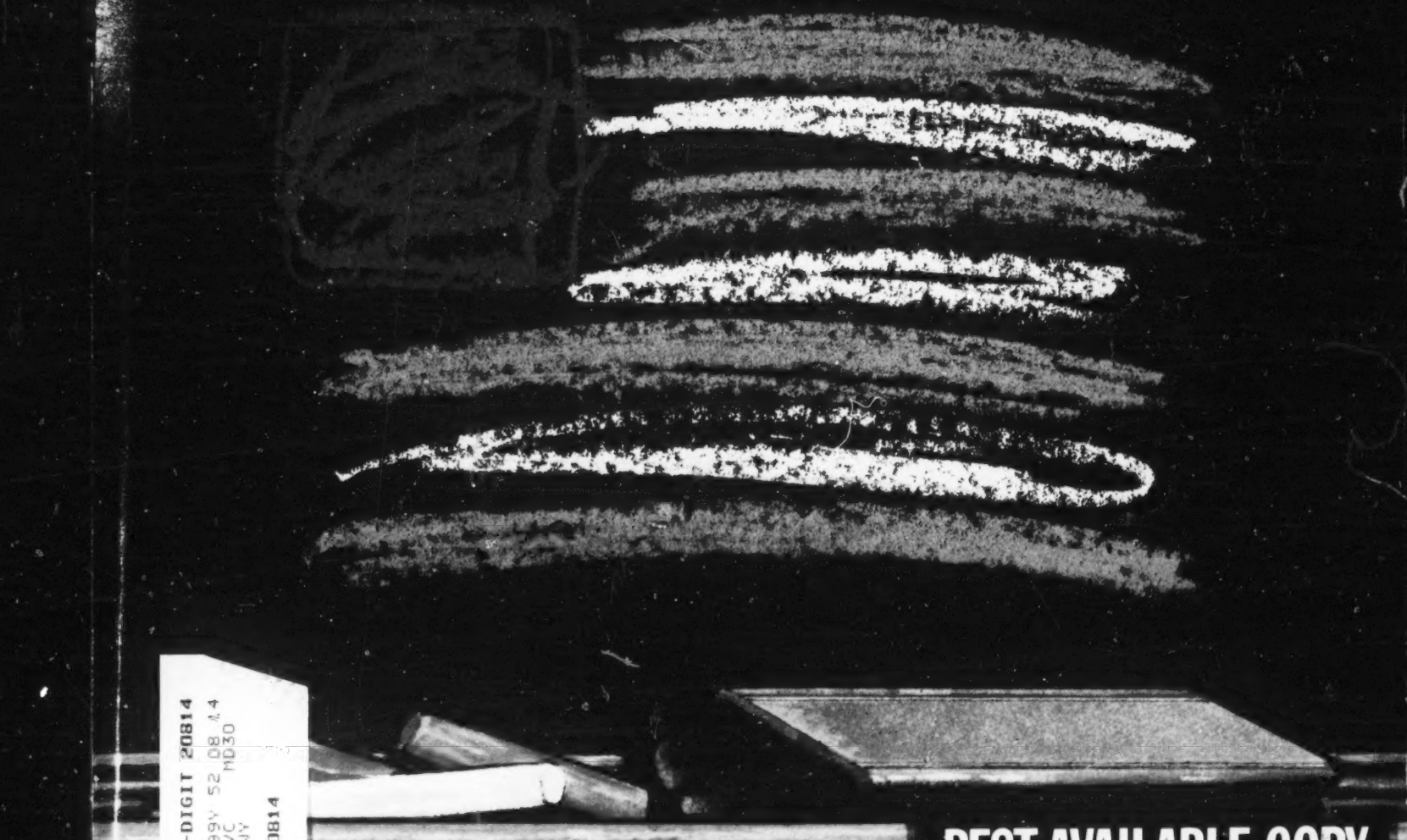
SPECIAL REPORT

WHAT TO DO ABOUT AMERICA'S SCHOOLS



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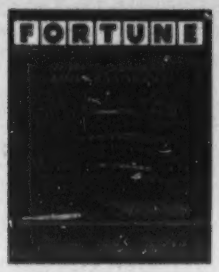

Like schoolchildren, artists work with chalk, though they generally call it pastel. Marc Rosenthal, whose work is familiar to readers of Office Hours, drew an American flag to symbolize the national concern about a national institution, the public schools. For a special report on their problems, see page 60.

FORTUNE

SPECIAL REPORT: EDUCATION

- What to Do About America's Schools *by Peter Brimelow* 60
- Vocational Education That Works *by Gilbert T. Sewall* 68
- A Fast Takeoff at Aviation High *(a picture portfolio)* 82
- An Alternative for Dropouts 85

AUTOS
Toyota Pulls Away from Nissan *by Henry Scott Stokes* 88

TAKEOVERS
Winning Strategies for Interstate Banking *by Orin Kramer* 104

COMPANIES
What Pulled the Rug from Under Walter E. Heller *by Ford S. Worthy* 124

MARKETING
SmithKline's Ulcer Medicine "Holy War" *by Joel Dreyfuss* 129

MANAGEMENT
How to Be a Better Negotiator *by Jeremy Main* 141

PROFILE
Irwin Jacobs from Bags to Moneybags *by Irwin Ross* 150

4
THE EDITOR'S DESK

6
IN THE NEWS
Harvester keeps trying, Khomeini coughs up, Charles Atkins's tax shelter, Computerland's growth—and more.

15
LETTERS TO FORTUNE
On specialty steel quotas, famous engineers, Warren Buffett, sexism, and other matters.

17
FORTUNE FORECAST
Summer's steady strength. The coming climb in food prices.

23
KEEPING UP
By Daniel Seligman

49
THE WASHINGTON CONNECTION
A farewell to deregulation, Boeing pickled—and more.

169
FOLLOW-UP
Banks as brokers, Tanner, RCA, Penn Square—and more.

171
PERSONAL INVESTING
A star stock picker, the best interest-rate spread around.

177
ON THE ROAD
Runners away from home.
By David Weld Stevens

193
BOOKS AND IDEAS
The De Lorean caper.
By Ann M. Morrison

205
OFFICE HOURS
What your vacation says about you.
By Walter Kiechel III

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WINNING STRATEGIES FOR INTERSTATE BANKING

■ The long-heralded consolidation of the U.S. banking industry is under way. With Congress still leery of letting banks leap across state boundaries, deregulation is taking place through the back door, in the states themselves. They have decided that since Congress will eventually act, they had better let local banks gather into large and presumably muscular institutions that can stand up to the money-center banks when interstate banking does arrive. So far, however, few banks have come up with coherent and promising strategies for the merger game.

In the 1970s the states loosened restrictions on growth and acquisitions inside state boundaries. Today multibank holding companies are permitted in 40 states, including such major markets as New York, California, Texas, Florida, Pennsylvania, and New Jersey. Now the states are paving the way to interstate competition. Last spring Massachusetts, Connecticut, and Rhode Island enacted legislation authorizing interstate acquisitions among banks in the three states, and Florida legislators are battling over a bill to make Florida the anchor of a similar multistate enclave in the Southeast. Other jurisdictions, ranging from California to Minnesota, have rejected the regional approach. They are thinking about following the lead of New York and Maine in permitting interstate marriages with banks in any state that enacts reciprocal legislation.

With interstate banking in sight, the industry's traditional love of size has become almost an obsession. Harry Keefe, the highly regarded banking specialist at Keefe Bruyette & Woods, asserts that the optimal size for a bank is at least $15 billion of assets (only 23 institutions meet his standard). Although bankers would differ on the precise number, Keefe's general sentiment is widely held. Says consultant John Mingo of Golembe Associates: "The driving rule is what's the biggest merger I can get away with on legal grounds if the economics and vibrations are right."

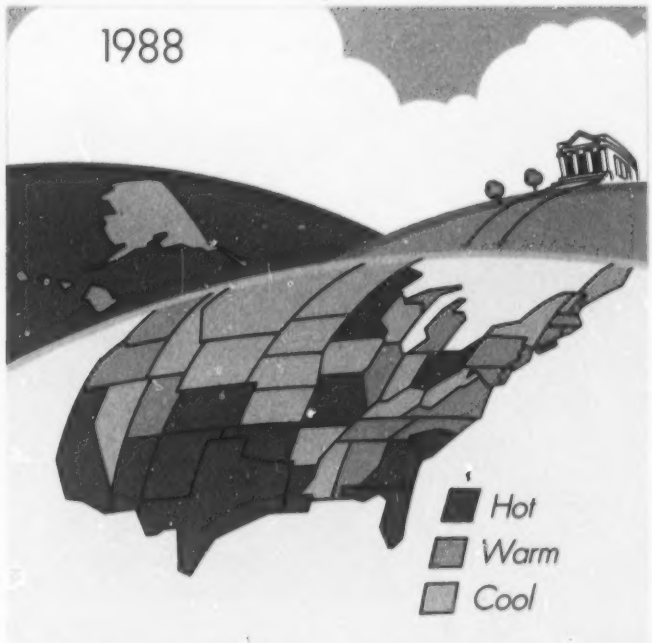
These trends and sentiments have produced an explosion in mergers and acquisitions. According to Earl E. Jackson III of Kidder Peabody & Co., the dollar volume of prices paid in major bank acquisitions jumped from $475 million in 1980 to $1.4 billion in 1981 to $3.6 billion in 1982. So far 1983 is running well ahead of last year's pace. The deals are also bigger than ever before. Two years ago no healthy bank with assets over $1 billion had ever been purchased by another U.S. bank. Today changing industry attitudes and liberalized antitrust standards from the main policeman of big bank mergers, the Federal Reserve, have made such deals common. David Cates of Cates Consulting Analysts notes that nine were announced in 1982 and ten in the first half of 1983.

Pennsylvania introduced statewide banking last year, and its experience serves as a model for what is happening or will happen in other states, in regions such as New England, and ultimately across the nation when full interstate banking is authorized. The game is dominated by the largest players. The mergers coupling Mellon National ($18 billion in assets) with Girard ($5 billion), and Pittsburgh National ($7 billion) with Provident National ($3 billion), reconfigured the state's banking structure and introduced a new force: the mega-regional bank. Faced with these new regional giants, the state's second-tier banks are also consolidating at an unprecedented rate. Eight out of 12 of the state's second-tier banks (institutions with from $750 million to $3 billion in assets) have been involved in major mergers or acquisitions over the past year. And the tiering effect in Pennsylvania—what William Weiant of First Boston Corp. calls "peer mergers" among the largest banks and defensive consolidations among smaller institutions—is evident today in New Jersey, Virginia, Ohio, Texas, and Florida.

YET MUCH OF THAT ACTIVITY is guided by the strategic perspective that drove merger and acquisition thinking in the 1970s, and this strategy is inadequate in the brutally competitive environment of the 1980s. "Simply stated, the conventional strategy has been and is to buy the biggest banks in the biggest, fastest-growing markets you're not in, and then move to smaller local markets on the same basis," says lawyer John D. Hawke Jr. of Arnold & Porter in Washington, D.C. Former Comptroller of the Currency John G. Heimann explains the allure of the old game: "When bankers have fought for something as long as they did for geographic deregulation, there's an almost Pavlovian tendency to capitalize on it as originally planned—even though the world's changed."

To be sure, size and a presence in high-growth markets offer distinct advantages. Historically a franchise in a growing market

ORIN KRAMER *was an adviser overseeing banking policy in the Carter White House and later a member of McKinsey & Co.'s financial institutions group.*



Over the near term, bank merger activity will be most intense in the traditional hotbeds, such as Texas and Florida, and in states like Nebraska, which recently authorized statewide banking. The 1988 map assumes Congress will have okayed interstate banking by then. The big California banks will move toward the Southwest, the Northeasterners into the Sunbelt, and all acquirers will seek to expand near their home markets. Vast stretches of the country outside major metropolitan areas will attract few bidders. The table below doesn't include bailouts of sick banks.

Biggest Bank Mergers 1982-83

PRICE* (millions)	Announcement Date	ACQUIRER Headquarters	ASSETS** (billions)	ACQUIREE Headquarters	ASSETS** (billions)
$515	6/21/83	MERCANTILE TEXAS Dallas	$10.2	SOUTHWEST BANCSHARES Houston	$6.9
$334	5/9/83	SUN BANKS OF FLORIDA Orlando	$5.0	FLAGSHIP BANKS Miami	$3.1
$288	7/26/83	FIRST CITY BANCORP OF TEXAS Houston	$16.6	CULLEN/FROST BANKERS San Antonio	$3.0
$282	4/30/82	INTERFIRST Dallas	$17.3	FIRST UNITED BANCORP Fort Worth	$2.4
$275	8/9/83	FIRST CHICAGO Chicago	$35.9	AMERICAN NATIONAL Chicago	$3.2
$269	7/14/83	CBT Hartford	$5.1	BANK OF NEW ENGLAND Boston	$5.1
$244	4/19/82	PITTSBURGH NATIONAL Pittsburgh	$6.9	PROVIDENT NATIONAL Philadelphia	$3.3
$220	8/2/82	MELLON NATIONAL Pittsburgh	$18.4	GIRARD Philadelphia	$4.8
$203	7/25/83	FIRST NATIONAL STATE BANCORP Newark	$4.9	FIDELITY UNION BANCORP Newark	$3.4
$175	2/25/83	VIRGINIA NATIONAL BANKSHARES Norfolk	$3.9	FIRST & MERCHANTS Richmond, Va.	$2.8

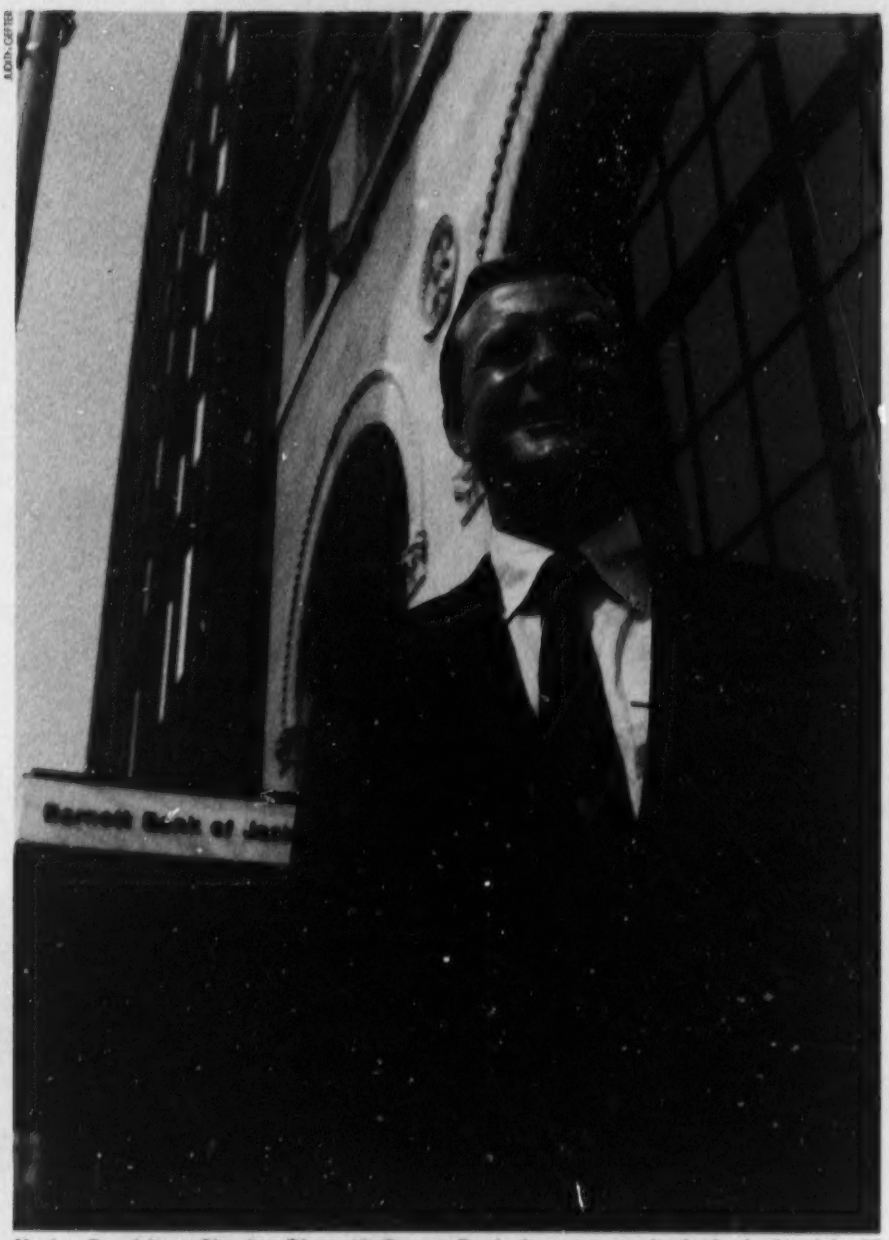
*Cash or stock being received by smaller of the two merger partners **Year-end prior to announcement

Source: Merrill Lynch Capital Markets

was sufficient to produce a high return on equity: among the ten FORTUNE 100 banks with the highest returns on shareholders' equity, five are in Texas, where the local economy floated along on the oil boom. Size brings higher lending limits and permission from the regulatory authorities to maintain less capital as a percentage of assets. Size also means access on more favorable terms to the equity and debt markets. And in an interstate environment, size is seen as a strategic imperative: size to achieve economies of scale, size to compete with money-center banks, size to ward off the unwanted acquirer. Indeed, bankers frequently suggest that many of today's transactions reflect "C.E.O. strategies"—efforts to preserve the autonomy or strengthen the prestige of management, without offering commensurate benefits for the shareholder.

The problem is that these traditional strategies are being implemented just as the economics of commercial banking are undergoing traumatic change. In recent years the preponderance of bank profits came from paying below-market interest rates to savers. To attract those lucrative deposits, banks built expensive branch systems: the number of branches grew from 11,000 in 1960 to 42,000 in 1982, and bank operating costs have been rising at an explosive annual rate of 14%. They currently total $35 billion, or nearly 1% of GNP. Now the cheap deposits that subsidized this expensive growth are disappearing with the elimination of interest rate ceilings. Yet according to Morgan Stanley analyst Arthur P. Soter, "The quantum cost reductions necessary to offset the loss of the rate subsidy are not yet happening."

INDUSTRY PROFITABILITY has already declined about 19% since 1979. Citicorp executives believe that today's average annual profit of $30 per retail customer will drop to $10 over the next few years for all but the most efficient banking organizations—an analysis with which some other leading retail bankers agree. In short,



Under President Charles Rice, *48, Barnett Banks became a market leader in 31 of the 37 Florida cities it has entered. Barnett will be a takeover target itself when interstate barriers fall.*

cutting expenses will be a central priority for successful banks in the 1980s, and merging high-cost institutions into one another will not by itself solve the problem. "A lot of bankers think they can kiss a frog and turn it into a princess," says an investment banker.

The reality is that the elimination of monopolies created by interest rate ceilings and geographic barriers requires hard new thinking. The most successful acquirers, banks that have been active buyers yet have maintained a high return on equity, are focusing primarily not on getting bigger but on producing profitability and a high stock price.

That's easier said than done, but can be done. The first requirement for a successful acquisition, the ticket that allows you to play the game, is a higher price-earnings multiple than those of your prospective targets. Studies have shown that market valuations of bank stocks are based primarily on return on equity, not earnings per share. Let's say you are doing well on the return-on-equity front, maybe because you're bright, maybe because you've got a grip on a lucrative market. You may be able to buy a bank in a high-growth area, one that complements your own operation. But you will have to pay a premium, which will probably mean at least some short-term dilution in your earnings per share. Then you will have to "earn back the premium," as bankers say, by improving the performance of the merged institutions. If not, your return on equity and your stock price could fall. You could become the gazelle rather than the tiger in the acquisition forest. Says John G. Medlin Jr., president of Wachovia Corp. in Winston-Salem: "The starting point is to view acquisition activity not as an end in itself but as a means of enhancing return on equity and shareholders' market value."

WHEREAS a franchise in an attractive market has been sufficient to produce a high return on equity, in a deregulated environment the winners will be those who, as William Wyman of Booz Allen & Hamilton puts it, "see banking as a set of separate lines of business, and focus on those businesses in which they either have lower costs or provide greater value than the competition." Wyman's prescription is counterintuitive for most of the industry. Most banks' merger activities are aimed at providing a full product line to all customer groups within a given geographic market, and few things are harder emotionally for most bankers than divesting a line of business—as Bankers Trust has done by selling off 150 branches and abandoning the mass market. But Manufacturers Hanover Chairman John F. McGillicuddy stresses the reality. "Offering 28 flavors of ice cream sounds exciting," he said in a speech early this year. "But it could well be that vanilla, chocolate, and strawberry provide 99.9% of your earnings." The key to success is "leveraging off strength," as Stephen T. McLin, strategic planning chief at Bank of America, puts it, and that concept is pushing banks with focused strategies in diverse directions. The common thread is agreement that getting bigger simply by entering high-growth markets won't suffice.

For many savvy acquirers, merger targets will be banks that can be used to serve the low end of the corporate market—companies with annual sales below $75 million. That focus largely reflects a process of elimination. Buying banks to serve the top of the corporate market makes no sense. This is a highly competitive business from which all but the strongest regional banks are retreating. Moreover, anybody who wants to compete with towering entities like Morgan Guaranty, Deutsche Bank, or Barclays can serve big corporate customers in Houston or Peoria through a small local office. By contrast, the low end of the corporate market offers major advantages. As even the largest

By buying small banks *serving the low end of the corporate market, President Gerald Smith, 53, built Houston's Allied Bancshares from $250 million in assets ten years ago to $6 billion today.*

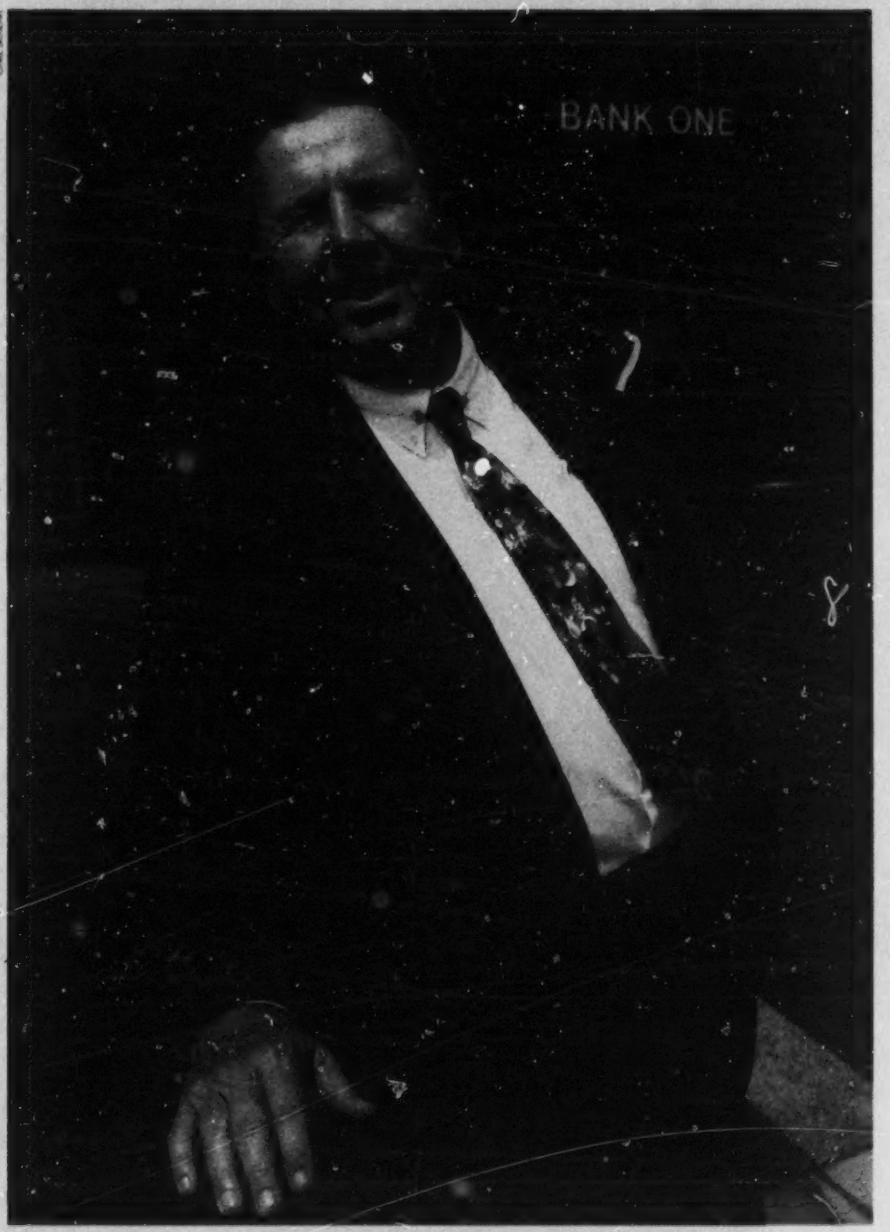
institutions concede, regional banks that know how to sort out the sheep from the goats and how to give the sheep a comfortable shave have nothing to fear from invaders. In this market, ten years of lunches count for much more than sophisticated advice about hedging foreign currencies.

The model for success through serving the lower middle market is Allied Bancshares in Houston, which has grown from a three-bank, $250-million holding company in 1973 to a 48-bank network with assets of $6 billion and a return on equity of 22.3% in 1982, the second highest (after State Street Boston Corp.) among FORTUNE's 100 largest banks. While its major Texas competitors have primarily bought large broad-line banks, Allied has concentrated on buying smaller banks serving what Roger Kline of McKinsey & Co. calls "the forgotten segment"—the so-called commercial or small-business market. Although only one-third the size of its bigger Houston competitors, Allied claims to have the largest market share among Houston area companies with annual sales of $5 million to $20 million.

Other sensible approaches to acquisitions are emerging, the most common of which is capitalizing on scale economies. Economists have long argued that scale economies in banking are limited, but new data suggest they can be significant and that they vary by line of business. The trick is to expand to the natural boundaries of a particular line. Sun Banks of Florida in Orlando, an efficient retailer, has the most automated teller machines (ATMs) of any Florida bank; its acquisition of the $3.1-billion Flagship Banks of Miami, which is fourth in the state in ATM coverage, will permit significant savings through consolidating data processing and other back-office operations. Bank of Boston manages over $6.7 billion in trust assets, making it one of the biggest players in the game. Its purchase of Casco-Northern in Maine will allow scale economies in managing Casco's substantial trust operations.

For today's most sophisticated acquirers, size is a component but not the critical element in their thinking. Twenty years ago Barnett Banks of Florida was a modest $250-million Jacksonville organization. In the interim it has made over 40 acquisitions, more than any other Florida bank holding company. When New York bankers are asked privately which Florida bank they would purchase given their druthers, Barnett tends to be the choice. To all appearances, Barnett is the classic aggressive acquirer, yet there are attractive Florida markets, such as Panama City, which it has declined to enter. Barnett is expanding within markets where it can be a major player. Of the 37 markets the bank is in, it is one of the top three players in 31. Sun Banks, third to Barnett among large Florida banks in return on equity, has a similar approach. Asked to identify the biggest shift in his thinking in recent years, Sun Chairman Joel Wells, who has had two decades of experience buying Florida banks, responds: "Showing the flag in every county is out."

HOW TO HANDLE the $1.8-trillion consumer market is the most dangerous issue facing merger-hungry banks. Consumer banking is still the heart of the business at most banks that will be up for sale. And despite the cost squeeze now beginning, consumer banking still produces most of the earnings for which an acquirer will pay. Consumer banking is not inherently unprofitable. Leading institutions around the world, operating under price deregulation and competitive conditions frequently comparable to those in the U.S., show returns on equity of 20% or more—a figure that Citicorp, for example, has achieved in New York City and in the 18 foreign countries where it has consumer operations. On the other hand, retail banking is the sector most vulnerable now to a decline in



Vice Chairman John G. McCoy, *70, equipped Banc One in Columbus, Ohio, with superb data-processing capability and turned it into a top performer, proving you can prosper in the heartland.*

earnings: it costs the average bank $150 to $200 per year to serve the average individual customer, and analysts believe bankers must cut that figure by at least one-third just to cover the higher costs of deposits.

The key to cutting costs, and the central challenge in retail banking, as McLin at Bank of America puts it, is "to migrate customers from the brick and mortar system to electronic delivery systems." Citicorp calculates that the average cost of a teller transaction is $1.27, compared with 55 cents for a machine transaction. If you double the customer volume of a brick and mortar branch, you'll need about twice as much staff; with ATMs, increased volume generates a far more modest rise in costs. And electronic systems are less sensitive to inflation.

The overwhelming majority of acquirers remain committed to retail banking, and among them three schools of thought are emerging. The first school, which includes most banks, has thought about the matter, but not deeply. It tends to regard talk of a retail profit squeeze as overblown and remains willing to pay big premiums for consumer-oriented banks. This school understands the need to go after the most profitable segments of the market, such as the affluent consumer, to reprice loans and services according to their true cost, and to close or sell off unprofitable branches. Yet this class of acquirers remains basically committed to serving the mass market through what consultant David Cates calls "a just plain uneconomic" brick and mortar system.

IN THE SECOND GROUP are banks that will go after the mass market with a full recognition of the need to convert to ATMs and highly automated back offices. Richard Rosenberg, a vice chairman of Wells Fargo, poses the issue well: "Am I buying a strong enough customer base to offset the prospective obsolescence of the delivery system?" Some 40% of routine transactions at Wells Fargo are done by machine today, and that figure is projected to reach 75% over the next few years. Likewise, Sun Banks and its acquirees are blanketing Florida with ATMs while reducing brick and mortar branches. Says Wells: "Our pruning is based on the old agricultural philosophy—to make your tree grow you have to cut back." Indeed, the business of divesting brick and mortar has become so active that a middle-size New Jersey investment banking firm, Ryan Beck & Co., which was once unknown outside its region, has created a lucrative nationwide niche for itself by advising on and carrying out the unloading of unwanted branch offices.

A third approach is the one adopted by Citicorp. Last year it bought Fidelity Savings of San Francisco, now Citicorp Savings, and reportedly was bidding for ailing Biscayne Federal Savings & Loan in Miami this summer. The general interpretation of these moves has been that aggressive Citi, prohibited by law from buying banks in those markets, was going after the closest thing to a bank available, and that if free to do so it would be first in line to buy big banks to penetrate the retail market. In reality, thrifts have lower operating costs than commercial banks because they generate more deposits per branch and provide fewer services. Citi regards them as superior vehicles for penetrating the mass market.

If sophisticated players like Citi are correct, the premiums often being paid to acquire retail banks don't make much sense. Most acquisition prices still reflect historic earnings or, worse still, the acquiree's book value, which is distorted by bank accounting practices and is a notoriously crude measure of net worth. "Historic earnings and book value give some measure of a bank's past record, but acquisition prices should be tied to what you can earn in the prospective environment," says Medlin of Wachovia. Conse-

quently, some potential acquirers plan to sit out this merger wave. "Prices will decline over time," observes a senior executive at a large New York bank, "so I wouldn't expect us to be a buyer in round one."

FOR OTHER REASONS as well, the much feared money-center banks will be secondary players in the acquisition game over the next few years. They are still barred from the most active markets, and they don't sport the high P/E ratios of today's leading acquirers. But the big banks are not entirely dormant: some have executed "when and if" agreements (for example, Chemical has agreed to take control of Florida National when the law permits), and many have prepared extensive contingency plans for interstate banking. Strategies vary, but the biggest banks generally look toward acquiring four or five large Sunbelt institutions, with particular emphasis on banks with heavy loan demand and a strong position in the corporate middle market.

Yet arguably the most distinctive feature of successful acquirers may be not their strategies but their skills in managing the acquisition process, which has two components. First, the acquirer needs special expertise and must devote substantial resources to the identification and negotiation of potential transactions. Chairman John F. Havens of Banc One in Columbus, Ohio, is a dealmaker by training, and he devotes 85% of his time to merger activity. Marc Shapiro, Texas Commerce's 36-year-old vice chairman, has overseen the bank's purchases and is considered one of the leading bank acquisition analysts in the country.

"The real test, though," says Chairman John P. LaWare of Boston's Shawmut Corp., "is achieving the economies that made the deal attractive in the first place." Managing acquisitions requires a delicate balance between allowing local units sufficient operating flexibility and centralizing overarching management decisions, but few banks give the issue adequate attention. Before getting into the Florida market through a legal loophole that let it use a long-standing trust operation to buy full-fledged banks, NCNB Corp. of Charlotte, North Carolina, spent months studying how to operate an interstate network. The study paid off—NCNB has been quite successful in Florida—but NCNB is the exception. The usual approach has been simply to vest the new subsidiary with broad operating autonomy, with the degree of independence rising as the size of the acquiree and distance between the two institutions increase. The result is that synergies have been largely imaginary; the performance of the acquired bank hasn't improved after the

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THE TREND toward mergers between peers has at least punctured the old myth that the big guys would gobble up the little guys in North Nook and Buzzard Pass. Thousands of such banks will survive, though most will see profits shrink as they have to pay higher rates to the townsfolk. Those that can roll over the higher-cost deposits into sound loans to local businesses will do quite well. They know their customers and provide personalized service that an intruder from the big city would be hard put to match.

With the merger wave centering on big banks, a fascinating counterpoint is the increasing receptivity among small banks to the thought that they might one day want to sell out. The value of their monopoly franchise plunged as soon as they had to start paying depositors more. "What is the best time to sell a small bank?" one analyst asks. "Last year."

The other urge to sell comes from what Bradford M. Johnson of Lehman Brothers Kuhn Loeb has characterized as the "demographics time bomb." Johnson notes that of the nation's 15,000 banks, some 11,500 have no public market for their stock. Shareholders, especially those with significant minority blocks, have a hard time selling out on a timely basis for fair market value.

Nearly two-thirds of the shareholders in institutions with assets under $500 million are over 50 years old, Johnson's studies show, and one-third are over 60. Contrary to myth, only 16% of shareholders in small banks are millionaires. The desire of small-bank shareholders to liquefy their holdings and the decreased interest among larger bank holding companies in purchasing smaller banks is likely to deflate the already declining premiums being paid for these institutions. Stephen Friedman, a former SEC commissioner and now an attorney with Debevoise & Plimpton, thinks some small bankers outwitted themselves: "They held out against geographic deregulation until their franchise had lost a lot of its value."

■ Before the freeing of consumer interest rates last fall, local banks were America's most entrenched monopoly, seemingly impregnable. Change still comes slowly in this world. Consumers don't shift deposits overnight. But the foundations of the monopoly have been swept away, and small banks are rethinking their stand against interstate banking. Within perhaps three to five years, enough will have switched position for interstate banking to carry the day in Congress. ■

Leading Takeover Candidates

COMPANY Headquarters	ASSETS 12/31/82 (billions)	MARKET VALUE 8/15/83 (millions)
FIRST PENNSYLVANIA Philadelphia	$5.4	$119
FIRST FLORIDA BANKS Tampa	$2.5	$272
RIHT Providence	$1.9	$93
NATIONAL BANCSHARES OF TEXAS San Antonio	$1.9	$198
TOLEDO TRUSTCORP Toledo	$1.7	$189
BANCTEXAS GROUP Dallas	$1.6	$179
COLONIAL BANCORP Waterbury, Conn.	$1.3	$63
FIRST NATIONAL BANCORP OF ALLENTOWN Allentown, Pa.	$1.1	$60
CONIFER/ESSEX GROUP Worcester, Mass.	$1.0	$61
MERRILL BANKSHARES Bangor, Maine	$0.6	$59

According to a FORTUNE survey *of over 60 bankers, these ten are among the banks likeliest to be gobbled up soon. Factors to look for include the growth rate of the target's market area, market share, financial condition (injured players such as First Pennsylvania are vulnerable), and management's receptivity to a bid. The list does not include banks that may be principals in "peer mergers," which don't carry big takeover premiums and so preclude a killing for speculators.*